FROM TAX COMPETITION TO SUBSIDY COMPETITION

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ABSTRACT

Recent international tax reforms provide an advantage to non-tax subsidies over economically equivalent tax benefits. Under several international tax standards, multinational enterprises are generally better off when they receive non-tax subsidies instead of equivalent tax benefits. As a result, countries now have a stronger incentive to adopt non-tax subsidies in order to attract the investment of multinational enterprises. This tax-driven preference for non-tax subsidies could shape the landscape of international tax and subsidy competition in the future. This Article contends that this preference cannot be justified on policy grounds. To treat equivalent measures similarly, this Article proposes several changes in the international tax standards, as well as the design of the OECD's recent proposal for a global minimum tax.

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TABLE OF CONTENTS

I. INTRODUCTION

Recent international tax reforms try to curb certain forms of international tax competition.[1] The Organization for Economic Co-operation and Development ("OECD")'s project on base erosion and profit shifting ("BEPS") targets measures and practices that enable multinational enterprises ("MNEs") to shift profits to jurisdictions where they pay little or no tax on that income.[2] Over 135 jurisdictions have committed to implementing the BEPS minimum standards.[3] Since late 2017, the EU has been blacklisting countries that do not meet certain international and EU tax standards.[4] Most

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[1] There is extensive literature concerning tax competition. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000); Richard Collier & Giorgia Maffini, *Tax Competition, Tax Co-operation and BEPS*, 3 J. TAX ADMIN. 22 (2017); TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (2018); David C. Elkins, *The Merits of Tax Competition in a Globalized Economy*, 91 IND. L.J. 905 (2016); Lilian V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory*, 71 TAX L. REV. 311 (2018); Michael Keen & Kai A. Konrad, *The Theory of International Tax Competition and Coordination*, *in* 5 HANDBOOK OF PUBLIC ECONOMICS 257 (Alan J. Auerbach, Raj Chetty, Martin Feldstein & Emmanuel Saez eds., 2013); Yoram Margalioth, *Tax Competition, Foreign Direct Investments and Growth: Using the Tax System To Promote Developing Countries*, 23 VA. TAX REV. 161 (2003); Jeffrey Owens, *The David H. Tillinghast Lecture Tax Competition: To Welcome or Not?*, 65 TAX L. REV. 173 (2012); Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555 (2009); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543 (2001); Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 WORLD TAX J. 67 (2009).

[2] For extensive literature on the BEPS project, see, e.g., Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185 (2016); Rifat Azam, *Ruling the World: Generating International Tax Norms in the Era of Globalization and BEPS*, 50 SUFFOLK U. L. REV. 517 (2017); Yariv Brauner, *Treaties in the Aftermath of BEPS*, 41 BROOK. J. INT'L L. 973 (2016); Irene Burgers & Irma Mosquera, *Corporate Taxation and BEPS: A Fair Slice for Developing Countries?*, 10 ERASMUS L. REV. 29 (2017); Allison Christians, *BEPS and the New International Tax Order*, 2016 BYU L. REV. 1603 (2016); Arthur J. Cockfield, *Shaping International Tax Law and Policy in Challenging Times*, 54 STAN. J. INT'L L. 223 (2018); Mindy Herzfeld, *The Case Against BEPS: Lessons for Tax Coordination*, 21 FLA. TAX REV. 1 (2017); WU INST. FOR AUSTRIAN AND INT'L TAX L., IMPLEMENTING KEY BEPS ACTIONS: WHERE DO WE STAND? (Michael Lang et al. eds., 2019); Ruth Mason, *The Transformation of International Tax*, 114 AM. J. INT'L L. 353 (2020).

[3] *See* OECD, OECD/G20 INCLUSIVE FRAMEWORK ON BEPS: PROGRESS REPORT JULY 2019 – JULY 2020, at 2-3 (2020), https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-progress-report-july-2019-july-2020.pdf [https://perma.cc/4V9M-MSAW].

[4] *See* discussion *infra* Section IV.b.

recently, the OECD has been developing a proposal for a global minimum tax.[5]

These reforms provide an advantage to non-tax subsidies over economically equivalent tax benefits. This Article analyzes the tax policy implications of this preference for non-tax subsidies. This is an important fiscal policy matter for many countries, as many jurisdictions compete over MNE investment by granting tax and non-tax incentives.[6]

Part III of this Article shows how three BEPS standards lead to the result that MNEs are generally better off when they receive non-tax subsidies rather than the equivalent tax benefits. First, a country-by-country ("CbC") report would show higher taxes paid and accrued where the MNE pays tax on its income and receives a subsidy equal to the tax.[7] The CbC report would show lower taxes paid and accrued where the MNE receives a tax benefit and generates income subject to no or low tax. Consequently, where the MNE receives a non-tax subsidy, its risk of being targeted by other countries' tax authorities for profit shifting would be lower. Second, countries that implement BEPS must exchange certain tax rulings, whereas the exchange of information regarding equivalent non-tax subsidies is not required.[8] Third, under the BEPS recommendations for controlled foreign corporation ("CFC") rules, a CFC that receives a non-tax subsidy and pays tax is more likely to be exempted from the CFC rules because it is subject to a higher effective tax rate.[9] A parent company of a CFC that receives a non-tax subsidy and pays tax on its income should be able to claim a tax credit for the amount of tax the CFC has paid, whereas no tax credit can be claimed if the CFC receives a tax benefit and does not pay tax.[10]

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5 *See* OECD, GLOBAL ANTI-BASE EROSION PROPOSAL ("GLOBE") - PILLAR TWO, ¶¶ 34-39 (2019), https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf [https://perma.cc/7RHS-B6V7].

6 *See* discussion *infra* Part II.

7 *See* discussion *infra* Section III.a.

8 *See* discussion *infra* Section III.b. These two standards—CbC reporting and spontaneous exchange of tax rulings—are part of the minimum standards under BEPS. OECD, *supra* note 3, at 14-17. All members of the Inclusive Framework must implement these standards. *See* OECD, INCLUSIVE FRAMEWORK ON BEPS: PROGRESS REPORT JULY 2016 - JUNE 2017, at 7 (2017), https://www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf [https://perma.cc/F8UA-K69R].

9 *See* discussion *infra* Section III.c.

10 *See* discussion *infra* Section III.c.

The OECD's recent proposal for a global minimum tax—titled by the OECD as the Global Anti-Base Erosion ("GloBE") proposal—has the potential to further increase the advantage of non-tax subsidies over equivalent tax benefits.[11] Similar to CFC rules, the proposed rules under the GloBE regime would generally impose lower taxes where a subsidiary receives a non-tax subsidy and pays tax on its income instead of receiving an equivalent tax benefit and paying no or low tax. The carve-outs in the OECD proposal, which are limited to a modest return on expenditures on payroll and tangible assets, might not fully exclude income benefitting from non-harmful tax incentive regimes. Therefore, the proposed GloBE regime would further reduce the benefit of non-harmful tax subsidies and increase the preference for equivalent non-tax subsidies.

Countries now have stronger incentives to adopt non-tax subsidies over tax benefits to attract MNE investment, as discussed in Part IV. As MNEs generally prefer non-tax subsidies over tax benefits, countries can attract more MNE investment at the same economic cost by granting non-tax subsidies instead of equivalent tax benefits. In addition, countries are now scrutinized by the OECD and the EU for their preferential tax regimes. A country that provides tax benefits is at risk of being accused of engaging in harmful tax competition by the OECD,[12] or of being blacklisted as a "non-cooperative tax jurisdiction" by the EU.[13] For example, South Korea was blacklisted by the EU in late 2017 for granting tax benefits to foreign investors.[14] These risks can be reduced by offering non-tax subsidies instead of tax benefits. The incentive for countries to move from international tax competition to international subsidy competition could shape the way countries compete for MNE investment in the future.

What are the implications of this tax-driven preference for non-tax subsidies? This Article argues that the preference for non-tax subsidies over equivalent tax subsidies might result in welfare losses. Treating equivalent *non-harmful* tax subsidies and non-tax

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11 OECD, PROGRAMME OF WORK TO DEVELOP A CONSENSUS SOLUTION TO THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY 26-29 (2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf [https://perma.cc/LC2E-GEUG]; *see also* discussion *infra* Section III.d.

12 *See* discussion *infra* Section IV.a.

13 *See* discussion *infra* Section IV.b.

14 *Id.*

subsidies differently could result in suboptimal governmental policies. Following David Weisbach and Jacob Nussim, the choice between an equivalent tax expenditure and a spending program should depend on which agency would optimally administer the scheme.[15] The tax-driven preference for non-tax subsidies might result in deadweight losses where the optimal instrument is a tax incentive scheme. In addition, welfare losses may occur where non-harmful tax benefits which increase welfare cannot be replaced with equivalent non-tax subsidies, or where they can be replaced but at a high cost. There is an additional risk that some countries might replace certain *harmful* tax subsidies with equivalent harmful non-tax subsidies. This could be the case where a country grants a subsidy designed to offset the recipients' tax liability with no substance requirement. In addition, while the EU has blacklisted countries for granting "ring-fenced" tax benefits to foreign investors only, [16] countries might adopt equivalent ring-fenced non-tax subsidies.

Therefore, this Article argues that international tax standards should not create a preference for non-tax subsidies over equivalent tax benefits. In addition to the efficiency considerations, this approach would be consistent with the principle of horizontal equity and would improve transparency. This approach is comparable to the WTO subsidy rules and the EU state aid rules that generally treat equivalent tax and non-tax subsidies similarly. Part V elaborates on these considerations and proposes several changes in the current international tax standards and the design of the proposed global minimum tax.

The Article is organized as follows: Part II provides background on subsidies and tax benefits. Part III shows how MNEs are better off when they receive non-tax subsidies instead of equivalent tax benefits. Part IV discusses countries' incentives to adopt non-tax subsidies instead of tax incentives. Part V considers the tax policy implications and proposes several changes in the international tax standards. Part VI provides a conclusion.

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15 *See* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 980 (2004).

16 *See* discussion *infra* Section IV.b.

II. BACKGROUND ON SUBSIDIES AND TAX BENEFITS

Governments can provide subsidies[17] through cash grants, tax benefits,[18] and other ways, such as allocating rights or providing goods or services at a rate below their market value. Where a subsidy is structured as a tax benefit, it is, in substance, a spending program administered through the tax system.[19]

It is generally possible to design a non-tax subsidy program (such as a cash grant scheme) so it would be economically equivalent to a tax incentive program, and vice versa.[20] For example, assume

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17 There is no general definition for the term "subsidy." For an in-depth discussion about the definition of "subsidy," see LUCA RUBINI, THE DEFINITION OF SUBSIDY AND STATE AID: WTO AND EC LAW IN COMPARATIVE PERSPECTIVE *passim* (2009). Under the WTO definition, a subsidy exists where a government or a public body confer a benefit through a financial contribution or price support. "Financial contribution" is defined broadly, and it includes fiscal incentives and tax benefits. *See* Agreement on Subsidies and Countervailing Measures art 1.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S 14 [hereinafter WTO Subsidies Agreement]; *see also* discussion *infra* Part V.

18 Tax benefits are generally benefits administered by the tax authority that impact the taxpayers' tax liability.

19 For an example of the extensive literature on tax expenditures, see Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) and the subsequent literature. *See also* STAFF OF J. COMM. ON TAX'N, 115TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016-2020, JCX-3-17, at 2 (2017) ("Special income tax provisions are referred to as tax expenditures because they may be analogous to direct outlay programs and may be considered alternative means of accomplishing similar budget policy objectives. Tax expenditures are similar to direct spending programs that function as entitlements to those who meet the established statutory criteria.").

20 *See* Weisbach & Nussim, *supra* note 15, at 961 ("As Stanley Surrey noted in his tax expenditures analysis, virtually any program can be implemented in at least two ways. It can be implemented through a direct spending program or through a tax program."); Jacob Nussim & Anat Sorek, *Theorizing Tax Incentives for Innovation*, 36 VA. TAX REV. 25, 58 (2017) ("Tax incentives and cash transfers are not the same thing, but tax incentives can be designed similarly to cash transfers, and vice versa. This is a straightforward insight, which originated the tax expenditures idea."); *see also id*. at 60 ("Any tax subsidy can be designed as an equivalent grant, and vice versa. Both provide cash to innovation processes; both can be similarly contingent on certain market variables, or not; both can allocate innovation risk in the same way; both may require the same amount of information for design and implementation."). This assumes that there are no political, institutional, and implementation constraints. Following Weisbach & Nussim, *supra* note 15, as no normative choice can be made between equivalent instruments, the choice of whether the subsidy should be granted as a tax benefit or as a cash grant largely depends on which government agency would optimally administer the scheme. For further articles implementing the approach proposed in Weisbach & Nussim,

that an MNE currently has an annual taxable income of $2,000 in Country X. This income is currently taxed at 20%—$400 in tax paid per year. The MNE considers opening a new research and development (R&D) center in Country X, but it will open it only if the government grants a tax benefit or a subsidy worth $400 per year. The benefits for Country X from the R&D center are expected to be greater than $400 per year. The government of Country X is indifferent about the design of the subsidy, which may be structured as one of the following incentives:

(a) A tax benefit that exempts the income of $2,000 from tax, thereby saving the annual tax liability of $400.

(b) Investment tax credits that offset the tax liability, thereby saving the annual tax liability of $400.

(c) An annual government grant of $500 that is subject to a tax of 20% so that the net benefit is $400.

(d) An annual government grant of $400 that is not subject to tax.

These options have a similar effect: The government grants the MNE a benefit of $400.

Designing equivalent non-tax subsidies and tax benefits might be simpler in some cases and more complicated in others. Tax benefits based on the taxpayer's expenditure (e.g., R&D investment) can be replaced with cash subsidies based on the same expenditure. For example, a refundable investment credit is equivalent to a cash subsidy with a matching requirement.[21] A non-refundable tax credit or a super deduction is equivalent to a subsidy that requires matching and is subject to a cap set at the recipient's tax liability.[22] However, where there is a direct link between the subsidy and the tax liability, there is a higher risk that other countries might treat the non-tax subsidy as a tax benefit in disguise. Less direct ways to design an equivalent non-tax subsidy would require estimating the expected tax liability and setting the cap accordingly.

Tax benefits that exempt income can be replaced with a non-tax subsidy based on an estimate of the expected tax liability without

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supra note 15, see Noam Noked, *Integrated Tax Policy Approach to Designing Research & Development Tax Benefits*, 34 VA. TAX REV. 109, 143 (2014); Noam Noked, *Designing R&D Incentives in Hong Kong*, 14 U. PA. ASIAN L. REV. 41 (2019).

21 *See* Noked, *Designing R&D Incentives in Hong Kong*, *supra* note 20, at 60.

22 *See id*.

the exemption,[23] or a subsidy subject to a cap set at the taxpayer's tax liability.[24] There may be cases where certain tax benefits cannot be substituted with non-tax subsidies that are entirely equivalent. Nonetheless, as MNEs and governments are repeat players, they can agree on mechanisms that achieve this equivalency over time, even if the substitution is imperfect.[25] Substituting tax benefits with non-tax subsidies and vice versa might not be possible; there may be political, legal and implementation constraints that limit the ability to replace some instruments with equivalent instruments.[26]

III. MNES' PREFERENCE FOR NON-TAX SUBSIDIES

This Part analyzes three BEPS standards that contribute to the advantage MNEs have when they receive non-tax subsidies instead of equivalent tax benefits: CbC reporting (Action 13), spontaneous exchange of tax rulings (Action 5), and the OECD recommendations for CFC rules (Action 3).[27] After discussing these BEPS standards, this Part also considers the potential impact of the OECD's recent proposal for a global minimum tax on the preference for non-tax subsidies.

a. Country-by-Country Reports

Many countries have started exchanging CbC reports since 2018. Tax authorities are expected to use these reports to identify where

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[23] Estimating the expected tax liability may be easier in some cases and harder in others. It would be easier to reliably estimate the tax liability where the MNE's income is stable, predictable, or where it depends on certain observable factors that can be used for the calculation of the subsidy (for example, where the income is calculated on a cost-plus basis, the subsidy can be calculated as a proportion of the relevant expenditure, similar to the calculation of the tax under the cost-plus method).

[24] As noted above, where there is a direct link between the subsidy to the recipient's tax liability, there is a higher risk that other countries might treat the subsidy as a tax subsidy in disguise.

[25] For example, a multi-year subsidy may be updated annually to correct for previous years' overpayment or underpayment.

[26] *See* Nussim & Sorek, *supra* note 20, at 58.

[27] In addition to these BEPS standards, it is possible that other BEPS standards that increase the pressure on tax competition also contribute to MNEs' preference for subsidies.

MNEs may have been engaged in profit shifting to low-or-no tax jurisdictions.[28] If, as a result of a tax benefit, an MNE pays no or low tax on its income in a particular jurisdiction, then there is a risk that other countries would tax that income. This risk would be lower if the MNE pays tax on its income and receives a non-tax subsidy equal to the value of the equivalent tax benefit.

When comparing the impact of various equivalent tax benefits and non-tax subsidies on the CbC report, the optimal incentive instrument is a non-tax subsidy subject to tax. This non-tax subsidy results in the highest tax liability and effective tax rate. The second-best option is a non-tax subsidy exempted from tax. Providing tax benefits—either through investment tax credits or a tax exemption—results in an even lower effective tax rate and income tax liability in the relevant jurisdiction. This is why tax benefits worsen the MNE's position in other jurisdictions that may impose tax on the untaxed or lightly taxed MNE income in the jurisdiction that grants the tax benefits.

Section III.a.i. provides a high-level summary of the CbC reporting requirements.[29] Section III.a.ii. discusses how various equivalent subsidies and tax benefits should be reflected in the CbC report. This is demonstrated in the example in Section III.a.iii.

i. General Requirements

Under BEPS Action 13,

> large MNEs are required to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of

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[28] For a discussion on the potential implications of the CbC reporting, see, e.g., Michelle Hanlon, *Country-by-Country Reporting and the International Allocation of Taxing Rights*, 72 BULL. FOR INT'L TAX'N 209 (2018). According to Hanlon, as a result of CbC reporting, MNEs will engage in less income shifting or move real economic activities to jurisdictions where they want to report income; CbC reporting will provide tax authorities with more data than what is currently available; governments will likely use this information to claim more taxing rights to MNEs' income; where countries claim more taxing rights, there is a risk of more conflicts between countries; and it is possible that CbC reporting might lead to abandoning the arm's length principle in favor of formulary apportionment or certain forms of source or destination-based taxation. *Id.* at 216.

[29] For further discussion on CbC reporting, see Noam Noked, Special Report, *Public Country-by-Country Reporting: The Shareholders' Case for Mandatory Disclosure*, 90 TAX NOTES INT'L 1501, 1502-03 (2018).

> revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction.[30]

MNEs with annual consolidated group revenues of at least 750 million euros must file CbC reports.[31]

The MNE should file the CbC report in the jurisdiction where the MNE's ultimate parent entity is resident, and that jurisdiction should exchange the information with the jurisdictions in which the MNE group operates if these jurisdictions meet certain conditions of confidentiality, consistency and appropriate use.[32] Where the ultimate parent entity's jurisdiction of residence does not exchange the CbC reports with other jurisdictions which satisfy the relevant conditions, other jurisdictions can require a local entity from the MNE group to file the CbC report for the whole group.[33] In general, the first reported year was 2016, and the reporting started in 2018.[34]

The CbC report requires the reporting of the following information for each of the jurisdictions where the MNE does business: revenues divided into revenues from related and

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30 *See* OECD, TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING, ACTION 13: 2015 FINAL REPORT 9 (2015) [hereinafter ACTION 13], https://www.oecd-ilibrary.org/docserver/9789264241480-en.pdf?expires=1607968695&id=id&accname=guest&checksum=ED816ADE849164B482AB47A4E680DFDE [https://perma.cc/W3Q9-B58J].

31 *Id*. at 10.

32 *Id*. ¶¶ 56-59.

33 *Id*.

34 *See id*. ¶ 50. While some countries followed this timeline, other countries have adopted or will adopt a more delayed implementation timeline. For example, in Hong Kong, the first year to be reported is 2018. Hong Kong MNEs may voluntarily file CbC reports for 2016 or 2017. The first exchange will take place later than 2018. *See* OECD, COUNTRY-BY-COUNTRY REPORTING – COMPILATION OF PEER REVIEW REPORTS (PHASE 2): INCLUSIVE FRAMEWORK ON BEPS: ACTION 13, at 231-36 (2019), https://www.oecd-ilibrary.org/docserver/f9bf1157-en.pdf?expires=1607968820&id=id&accname=guest&checksum=EE9E9A87779C961DED2DF27F09B07704 [https://perma.cc/XDY7-H49S].

unrelated parties,[35] profit (loss) before income tax,[36] income tax paid (on cash basis),[37] income tax accrued in the current year, stated capital, accumulated earnings, number of employees, and tangible assets other than cash and cash equivalents.[38]

Income tax cash payments are generally less susceptible to accounting manipulation, so it is possible that tax authorities will pay close attention to the income tax paid and to the ratio of the income tax paid to the before-tax profits or the revenues. The discussion below shows that the choice between equivalent instruments has substantial implications on the income tax liability and these ratios.

Action 13 does not instruct which accounting principles should be used by MNEs when preparing the CbC reports. Action 13 noted that each MNE "may choose to use data from its consolidation reporting packages, from separate entity statutory financial statements, regulatory financial statements, or internal management accounts."[39] The discussion below assumes that the MNE uses the financial statements as the source of data for the CbC report, and that the relevant accounting standards generally follow the International Accounting Standards ("IAS").

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[35] In the "Revenues" column, the MNE should report the following:

> (i) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with associated enterprises; (ii) the sum of revenues of all the Constituent Entities of the MNE group in the relevant tax jurisdiction generated from transactions with independent parties; and (iii) the total of (i) and (ii). Revenues should include revenues from sales of inventory and properties, services, royalties, interest, premiums and any other amounts.

ACTION 13, *supra* note 31, at 33.

[36] In the "Profit (Loss) before Income Tax" column, the MNE should report "the sum of the profit (loss) before income tax for all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The profit (loss) before income tax should include all extraordinary income and expense items." *Id*.

[37] In the "Income Tax Paid (on Cash Basis)" column the MNE should report "the total amount of income tax actually paid during the relevant fiscal year by all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction." *Id*.

[38] *Id.* at 29.

[39] *Id.* at 32.

ii. How Subsidies and Tax Benefits Affect the CbC Reports

How will subsidies to MNEs be reflected in CbC reports? IAS 20 provides guidance on the accounting of government grants and other forms of government assistance.[40] In general, an entity can recognize a government grant when there is reasonable assurance that the entity will comply with the conditions attached to the grant,[41] and that the grant will be received.[42] The income should be recognized over the period in which the related costs are incurred.[43] Grants should be presented in the income statement either separately or as "other income."[44] Alternatively, it is possible to deduct the grants from the related expenses.[45] IAS 20 does not apply to government assistance in the form of tax incentives.[46] When grants are recognized as income or as a reduction of an expense, this should increase the "Profit (Loss) before Income Tax" column in the CbC report. Under Action 13 and the applicable OECD guidance, it appears that grants recognized as income should be included in the "Revenues" column in the CbC report.[47] It is unclear whether grants

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40 INT'L. ACCT. STANDARDS BD., INTERNATIONAL ACCOUNTING STANDARD 20, ACCOUNTING FOR GOVERNMENT GRANTS AND THE DISCLOSURE OF GOVERNMENT ASSISTANCE (1983) [hereinafter IAS 20].

41 "Government grants" are defined broadly as

> assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Id. ¶ 3.

42 *Id.* ¶ 7.

43 *Id.* ¶ 12.

44 *Id.* ¶ 29.

45 *See id.*

46 *Id.* ¶ 2(b) (limiting the scope of IAS to not include "government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability. Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates").

47 ACTION 13, *supra* note 30, at 33. The OECD guidance also provides that "[a]ll revenue, gains, income, or other inflows shown in the financial statement prepared in accordance with the applicable accounting rules relating to profit and loss, such as the income statement or profit and loss statement, should be reported as Revenues in Table 1." OECD, GUIDANCE ON THE IMPLEMENTATION OF COUNTRY-BY-COUNTRY REPORTING, BEPS ACTION 13, at 7 (2019) [hereinafter OECD GUIDANCE],

should be included in the "Revenues" column where the grants are treated as a reduction of the relevant expense. The impact of the grant on the "Income Tax Paid (On Cash Basis)"[48] column depends on whether the grant is exempted from income tax.[49] If the grant is subject to tax, then this additional tax will increase the entity's tax liability. If the grant is exempted from taxation, then it will not increase the tax liability.

Tax benefits that are not investment tax credits (e.g., a tax exemption) should be disclosed separately,[50] and not as part of the entity's revenues or income before tax. Thus, if a tax benefit (other than investment tax credit) is received, it will not increase the CbC report's revenues and profit (loss) before income tax. A tax benefit would reduce the "Income tax paid" column because the tax paid would be lower if a tax benefit is received.

Investment tax credits are excluded from both IAS 20 and IAS 12, and the International Financial Reporting Standards ("IFRS") do not provide guidance on how they should be reflected in the

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https://www.oecd.org/ctp/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf [https://perma.cc/RZ2G-M2TT]. According to the OECD guidance, the "Revenues" also include income items such as "other income" that may not be included in the revenue line of the income statement. *Id.* ("For example, if the income statement prepared in accordance with the applicable accounting rules shows sales revenue, net capital gains from sales of assets, unrealized gains, interest received, and extraordinary income, the amount of those items reported in the income statement should be aggregated and reported as Revenues in Table 1.").

48 This column is referred to as "Income Tax Paid" in the discussion below.

49 The taxation of grants depends on the terms of each particular grant and the domestic tax law in the relevant jurisdiction. For example, Canada, Australia, and Singapore apply different tax rules to different grants. *See* TOVA EPP, GOVERNMENT GRANTS AND THEIR TAX TREATMENTS (2018), https://static1.squarespace.com/static/5565ecede4b0df78d78d2b36/t/5bc6926de2c483c657da646f/1539740274622/GovernmentGrantsWhitepaper.pdf [https://perma.cc/X27T-FVEH] (for Canada); CPA AUSTRALIA, GRANTS IN AUSTRALIA (2012), https://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/notforprofit/grants-in-australia.pdf [https://perma.cc/366G-UL3T] (for Australia); *Tax Treatment of Grants/Payouts Commonly Received by Companies*, INLAND REVENUE AUTH. SING. (May 2020), https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Taxable-and-Non-Taxable-Income/Tax-Treatment-of-Grants/-Payouts-Commonly-Received-by-Companies/ [https://perma.cc/WB4E-8J4K] (for Singapore).

50 INT'L. ACCT. STANDARDS BD., INTERNATIONAL ACCOUNTING STANDARD 12, at § 79 (1996) [hereinafter IAS 12].

financial statements.[51] The accounting treatment of investment tax credits depends on the applicable domestic legislation, group policy, and other factors, such as whether the investment tax credits are refundable (i.e., can be settled with cash).[52] For example, in 2013 the United Kingdom introduced the Research and Development Expenditure Credit (also known as the "above the line" credit), which provides a tax credit for qualifying R&D expenditure.[53] This credit is similar to a subsidy because it is payable in cash, net of tax, to companies with no tax liability.[54] The accounting treatment of this credit would likely be similar to the treatment of a government grant. Other investment tax credits may be reported similarly to other tax benefits, resulting in no impact on the "Revenues" and "Profit (Loss) before Income Tax" columns. If the entity that receives the credit has taxable income before applying the credit, receiving this credit should reduce the "Income Tax Paid (on Cash Basis)" column.

Table 1 summarizes how government grants, investment tax credits, and tax benefits other than investment tax credits should be reflected in the following columns of the CbC report: "Revenues," "Profit (Loss) before Income Tax," and "Income Tax Paid."

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51 *See* Silvia, *Tax Incentives - IAS 12 or IAS 20?,* CPD BOX (2015), https://www.cpdbox.com/tax-incentives-accounting-ifrs/ [https://perma.cc/BC2G-5J4T]; Valerie Boissou, KPMG, *Government Grants: IFRS Compared to US GAAP* (May 31, 2019), https://advisory.kpmg.us/articles/2019/government-grants-ifrs-compared-to-us-gaap.html [https://perma.cc/G8FS-WBGE].

52 *See id.*

53 Kathie Haunton & Sarah Goodman, *Taking the Credit*, TAXADVISER (Aug. 1, 2015), https://www.taxadvisermagazine.com/article/taking-credit [https://perma.cc/A2AN-VGMZ]; *see Research and Development (R&D) Expenditure Credit,* GOV.UK (Jan. 1, 2007), https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-large-companies [https://perma.cc/TJU7-YUF8].

54 For additional guidance, see Haunton & Goodman, *supra* note 54.

Table 1

CbC Report Item	Government Grants	Tax Benefits Other Than Investment Tax Credits	Investment Tax Credits
Revenues and Profit (Loss) Before Income Tax	Government grants increase the "Revenues" and the "Profit (loss) before tax" columns.	Tax benefits generally do not affect the "Revenues" and the "Profit (loss) before tax" columns.	Depending on the terms of the credits and the accounting policy, investment tax credits may or may not affect the "Revenues" and the "Profit (loss) before tax" columns.
Income Tax Paid (on Cash Basis)	Depending on the specific terms, a government grant may or may not be subject to corporate income tax.	Tax benefits generally reduce the "Income tax paid" column.	Investment tax credits generally reduce the "Income tax paid" column.

iii. Example

This example demonstrates the impact of equivalent non-tax subsidies and tax benefits on the CbC report. In this example, an MNE currently has annual revenues of $2,500 and an annual profit before tax of $2,000 in Country X. This profit is currently taxed at 20%—$400 in tax paid per year. Assume that an MNE is considering opening a new R&D center in Country X. It will open the R&D center in Country X only if the government grants a tax benefit or a non-tax subsidy worth $400 per year. The benefits for Country X from the R&D center are expected to be greater than $400 per year. The government of Country X is indifferent about the design of the subsidy, which may be structured as one of the following incentives:

(a) Tax benefits (which are not investment tax credits) that exempt the income before tax of $2,000, thereby eliminating the annual tax liability of $400.

(b) Investment tax credits that offset the tax liability, thereby eliminating the annual tax liability of $400.

(c) An annual government grant of 500 that is subject to tax of 20%, so that the net benefit is $400.

(d) An annual government grant of $400 that is not subject to tax.

Table 2 summarizes how each incentive will be reflected in the MNE's CbC report. Units are United States Dollars unless otherwise indicated.

Table 2

Item in the CbC report	**Before the incentive**	**(a) Tax exemption**	**(b) Investment tax credits**	**(c) Grant subject to tax**	**(d) Grant not subject to tax**
Revenues	2,500	2,500	2,500 or 2,900	3,000	2,900
Profit (loss) before income tax	2,000	2,000	2,000 or 2,400	2,500	2,400
Income tax paid	400	0	0	500	400
Net benefit	0	400	400	400	400
Ratio of income tax paid to revenues	16.66%	0%	0%	16.66%	13.79%
Ratio of income tax paid to profit before income tax	20%	0%	0%	20%	16.66%

Under option (a), the tax exemption does not increase the "Revenues" and the "Profit (Loss) Before Tax" columns, and they remain unchanged ($2,500 and $2,000, respectively). The tax exemption reduces the tax liability to zero, resulting in an effective tax rate of zero—much lower than the effective tax rate of 20% before granting the subsidy.

Under option (b), some investment tax credits may not affect the "Revenues" and "Profit (Loss) Before Tax" columns, while other investment tax credits (e.g., "above the line" credits) may increase them. The exact accounting treatment depends on the terms of the credits and the accounting policy. Similar to option (a), the investment tax credits reduce the tax liability to zero, and the effective tax rate is zero.

Under option (c), we assume that the government grant of $500 is subject to corporate income tax. As the government grant should generally be included in the "Revenues"[55] and the "Profit (Loss) Before Tax" columns, they increase to $3,000 and $2,500, respectively. The "Income Tax Paid" column increases from $400 to $500 because of the additional tax on the government grant. The effective tax rate, calculated as the ratio of the income tax paid to profit (loss) before tax, is 20%, similar to the effective tax rate before granting the non-tax subsidy.

Under option (d), we assume that the government grant of $400 is exempted from corporate income tax. The grant should be included in the "Revenues" and the "Profit (Loss) Before Tax" columns, so that they increase to $2,900 and $2,400, respectively. As the tax liability remains the same, the "Income Tax Paid" column remains $400. The effective tax rate is 16.66%, lower than the effective tax rate before granting the non-tax subsidy, but substantially higher than zero as in options (a) and (b).

Although all four alternatives provide subsidies with the same economic value ($400), they vary in their impact on the MNE's CbC report. Consequently, the resulting risks for the MNE differ substantially. From a CbC reporting perspective, the optimal subsidy would follow alternative (c)—a government grant subject to tax—because this subsidy shows the highest tax liability and the highest effective tax rate. The second-best option follows alternative (d) as it results in lower tax liability and effective tax rate. Options (a) and (b)—providing tax benefits—put the MNE in the worst position because tax authorities in other jurisdictions might try to

[55] As noted in Section III.a.ii., *supra*, it is unclear if a government grant should be reflected in the "Revenues" column if the MNE records the grant as a reduction of a relevant expense and not as income, although in principle this appears to be the correct approach. This example assumes that the grant has been recorded as income, and thus it should be included in the "Revenues" column in the CbC report.

tax the untaxed income in Country X, claiming that the MNE shifted profits to that jurisdiction in order to avoid taxation in other jurisdictions.

This example demonstrates another important point about the effect of CbC reporting. Although the OECD has stated that BEPS measures should target only instances where MNEs "artificially shift profits to low or no-tax locations where there is little or no economic activity,"[56] they, in fact, discourage all tax benefits, including tax benefits for substantial economic activities. For example, if a MNE does not pay tax on its profits in Hong Kong or Singapore because it receives tax benefits for investing in R&D activities in those jurisdictions, the CbC report will reveal no income tax paid or accrued, thereby exposing the MNE to a higher risk of other countries' tax authorities arguing that the MNE shifted profits to those jurisdictions to avoid taxation.

Where an MNE pays low taxes as a result of receiving non-harmful tax benefits for the income generated in the relevant jurisdiction that provided the tax benefits, the MNE should be able to explain that to other countries' tax authorities, and they should not tax that income. However, in reality, the reporting of untaxed or lightly taxed income puts the MNE at risk because of the increased risk for audits and disputes, the risk that other countries' tax authorities might reject the MNE's explanations, and the risk that some tax authorities might misuse the CbC reporting.[57]

b. Spontaneous Exchange of Tax Rulings

BEPS Action 5 states that countries which joined the BEPS Inclusive Framework must spontaneously exchange certain tax rulings with certain jurisdictions.[58] The term "ruling" means "any

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[56] *What is BEPS?: What is the Issue?,* OECD (2019), http://www.oecd.org/ctp/beps-about.htm [https://perma.cc/838R-6WFM]. Similar language appears in the BEPS action plan and final reports. *See* OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: EXPLANATORY STATEMENT: 2015 FINAL REPORT 14 (2015), https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf [https://perma.cc/22EJ-QHER].

[57] *See*, e.g., William Hoke, *Multinationals Concerned about Misuse of CbC Reports*, 85 TAX NOTES INT'L 409 (2017).

[58] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE: ACTION 5: 2015 FINAL REPORT 45-46 (2015),

advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely."[59] Rulings concerning preferential tax regimes must be exchanged.

Rulings concerning non-tax subsidies are outside the scope of this definition. Tax authorities typically do not provide any advice, information, or undertaking about non-tax subsidies. In addition, non-tax subsidies do not directly affect a taxpayer's "tax situation." Action 5 neither discusses nor mentions subsidies, government grants, or other non-tax government incentives. Thus, non-tax subsidies are generally not subject to compulsory spontaneous exchange which applies to tax rulings under BEPS.

Before the compulsory spontaneous exchange under Action 5, other countries affected by tax rulings may not have been aware of them. Now, when other countries know about the rulings, there is a higher likelihood that those other countries will audit the MNEs that receive the tax benefits under these tax rulings and impose higher taxes if the rulings are used for profit shifting.

To avoid the reporting of the incentives granted under a reportable tax ruling, governments may provide equivalent non-tax

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https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1607969397&id=id&accname=guest&checksum=67EC66CBF667728AEE243D3E71EF3233 [https://perma.cc/4AJF-AGYT]. The jurisdictions that receive the rulings are generally the jurisdictions

> of residence of all related parties with which the taxpayer enters into a transaction for which a ruling is granted or which gives rise to income from related parties benefiting from a preferential treatment . . . and the residence [jurisdiction] of the ultimate parent company and the immediate parent company.

Id. ¶ 121.

[59] *Id.* ¶ 95 (footnote omitted). Action 5 provides a list of six categories of taxpayer-specific rulings to which the compulsory spontaneous exchange applies:

> (i) rulings relating to preferential regimes; (ii) unilateral APAs [advance pricing agreements] or other cross-border unilateral rulings in respect of transfer pricing; (iii) cross-border rulings providing for a downward adjustment of taxable profits; (iv) permanent establishment (PE) rulings; (v) related party conduit rulings; and (vi) any other type of ruling agreed by the FHTP [Forum on Harmful Tax Practices] that in the absence of spontaneous information exchange gives rise to BEPS concerns.

Id. ¶ 91.

subsidies. Such non-tax subsidies may be kept confidential if the disclosure is not required under other laws.[60]

c. CFC Rules

BEPS Action 3 provides recommendations for the design of CFC rules. Although these recommendations are considered as non-binding "soft law," the OECD notes that "there is an expectation that they will be implemented accordingly by countries that are part of the consensus."[61]

One of the OECD recommendations is "to include a tax rate exemption that would allow companies that are subject to an effective tax rate that is sufficiently similar to the tax rate applied in the parent jurisdiction not to be subject to CFC taxation."[62] The tax rate exemption requires that the rate at which the CFC was taxed be below a certain threshold, which could be a particular fixed rate (e.g., ten percent) or a percentage of the parent country's own rate on a similar income.[63] Once the threshold has been determined, the tax rate in the CFC jurisdiction should be compared to the threshold. Action 3 recommends using the effective rate of the CFC itself and not the nominal or statutory tax rate in the jurisdiction of the CFC.[64] The calculation of the effective tax rate is based on the ratio of the actual tax paid in the CFC jurisdiction to the total taxable income.[65]

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[60] Disclosure of certain subsidies may be required under the WTO subsidy rules and the EU state aid rules. *See* Commission Regulation 651/2014, 2014 O.J. (L 187) 1 (EU); Commission Regulation 1388/2014, 2014 O.J. (L 369) 37 (EU); Commission Regulation 702/2014, 2014 O.J. (L 193) 1 (EU); WORLD TRADE ORG., WORLD TRADE REPORT 2006, at 194 (2006), https://www.wto.org/English/res_e/booksp_e/anrep_e/world_trade_report06_e.pdf [https://perma.cc/A6VX-B2BX]. However, many subsidies are not within the scope of these rules.

[61] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: 2015 FINAL REPORTS: FREQUENTLY ASKED QUESTIONS 5 (2015), https://www.oecd.org/ctp/beps-frequently-asked-questions.pdf [https://perma.cc/P4CG-7E9K].

[62] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: DEFINING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES: ACTION 3: 2015 FINAL REPORT ¶ 51 (2015), https://www.oecd-ilibrary.org/docserver/9789264241152-en.pdf?expires=1607969647&id=id&accname=guest&checksum=4BCF8B61DC243EC8962B7701AC099AFB [https://perma.cc/YC4L-A7KQ].

[63] *See id.* ¶ 63.

[64] *See id.* ¶ 65.

[65] *See id.* ¶ 66. This calculation typically follows the rules of the parent's country or the IFRS.

Another OECD recommendation is to provide a tax credit for foreign taxes paid by the CFC where its income is subject to foreign tax.[66]

Where these recommendations are followed, MNEs should generally be better off when their CFCs receive non-tax subsidies instead of tax benefits. For example, assume that a CFC which reports taxable income of $2,000 in a jurisdiction with a corporate income tax rate of twenty percent can choose between the following alternatives:

(a) Tax benefit that will reduce its tax liability to zero, thereby saving $400.

(b) Subsidy of $500 that is subject to tax, resulting in a net benefit of $400.

(c) Subsidy of $400 that is not subject to tax.

Table 3 summarizes the taxable income, tax liability, and effective tax rate for the three alternatives.

Table 3

	(a) Tax benefits	(b) Subsidy subject to tax	(c) Subsidy not subject to tax
Taxable income	2,000	2,500	2,000[67]
Income tax	0	500	400
Effective tax rate	0%	20%	20%

If the CFC receives a subsidy, the effective tax rate will be twenty percent. If the CFC receives a tax benefit, the tax rate would be zero percent. A higher effective tax rate is more likely to qualify for a tax rate exemption under other countries' CFC rules. In addition, even if the effective tax rate is below the exemption threshold, a parent company of a CFC that receives a non-tax subsidy and pays tax on its taxable income should be able to claim a tax credit for the tax the CFC paid. A parent company of a CFC that receives a tax benefit and does not pay any tax cannot claim any credit. Therefore, the

[66] *See id*. ¶¶ 122-27.

[67] If the subsidy amount is included in the taxable income, then the figure should be 2,400, and the effective tax rate should be 16.66%. There is no clear guidance on whether a tax-exempt subsidy should be included in the CFC's income for the purpose of applying the CFC rules.

application of CFC rules following the OECD recommendations would favor CFCs that receive non-tax subsidies and disfavor CFCs that receive equivalent tax benefits.

d. Proposal for a Global Minimum Tax

The OECD is now developing a proposal for a global minimum tax as part of the OECD's work on international tax challenges arising from the digital economy.[68] The OECD's recent proposals are grouped into two pillars: Pillar One addresses the challenges of the cross-border digital economy by allocating the taxing rights with respect to such businesses.[69] Pillar Two's scope is much broader, as it "focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to 'tax back' where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation."[70] The OECD's proposal under Pillar Two—the GloBE proposal—is a proposal for a global minimum tax. Although this proposal has been developed as part of the OECD's work on challenges arising from the digital economy, the envisaged global minimum tax would not be limited only to the digital economy.[71] The OECD has noted that "it proposes a systematic solution

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[68] OECD, OECD/G20 BASE EROSION AND PROJECT SHIFTING PROJECT: PUBLIC CONSULTATION DOCUMENT: ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY (2019), https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf [https://perma.cc/J8NZ-WQ9K]. For further discussion about the GloBE proposal and the design considerations, see LUC DE BROE, ROBERT J. DANON & VIKRAM CHAND, COMMENTS TO PUBLIC CONSULTATION DOCUMENT: GLOBAL ANTI-BASE EROSION PROPOSAL ("GLOBE") – PILLAR TWO 8-9 (2019), https://serval.unil.ch/resource/serval:BIB_D8C1987EFA9C.P001/REF [https://perma.cc/4492-V38Y]; MICHAEL P. DEVEREUX ET AL., THE OECD GLOBAL ANTI-BASE EROSION PROPOSAL 18-19 (2020), https://www.sbs.ox.ac.uk/sites/default/files/2020-02/OECD_GloBE_proposal_report.pdf [https://perma.cc/2F8Y-SFPS]; Lorraine Eden, *Taxing Multinationals: The GloBE Proposal for a Global Minimum Tax*, 49 TAX MGMT. INT'L J. 1 (2020); Joachim Englisch & Johannes Becker, *International Effective Minimum Taxation – The GLOBE Proposal*, 11 WORLD TAX J. 483 (2019). For further discussion on the GloBE regime and potential reactions of affected countries, see Noam Noked, *Defense of Primary Taxing Rights*, 40 VA. TAX REV. (forthcoming 2021).

[69] OECD, *supra* note 11, ¶ 11.

[70] *Id.*

[71] *Id.*

designed to ensure that all internationally operating businesses pay a minimum level of tax."[72]

In October 2020, the OECD published a blueprint for Pillar Two which lays out the OECD's detailed proposal for the design of the GloBE regime.[73] In this publication, the OECD stated that "[t]he finalisation of Pillar Two also requires political agreement on key design features of the subject to tax rule and the GloBE rules including carve-outs, blending, rule order and tax rates where, at present, diverging views continue to exist."[74] The OECD also noted that it intends to "swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021 and to resolve technical issues, develop model draft legislation, guidelines, and international rules and processes as necessary to enable jurisdictions to implement a consensus based solution."[75]

The OECD proposal includes four rules: the income inclusion rule, the undertaxed payments rule, the switch-over rule, and the subject to tax rule.[76] The income inclusion rule "would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate."[77]

This rule is a form of a global, unified CFC regime which imposes taxation on CFC income where it is lightly taxed.[78] Thus, the discussion above with respect to the impact of CFC rules on the preference for non-tax subsidies is relevant here: Taxation under the income inclusion rule is less likely to be triggered where a subsidiary or a branch[79] receives a non-tax subsidy because the effective tax rate would be higher. Under the OECD proposal, non-tax government grants should be considered as income; refundable tax credits that meet certain conditions should also be treated as income; and

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72 *Id.* ¶ 55.

73 OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: TAX CHALLENGES ARISING FROM DIGITALISATION – REPORT ON PILLAR TWO BLUEPRINT (2020) [hereinafter BLUEPRINT], https://www.oecd-ilibrary.org/docserver/abb4c3d1-en.pdf?expires=1607959735&id=id&accname=guest&checksum=51E3276343C90F0D14BCC591ECA7F40F [https://perma.cc/WH3T-U3KT].

74 *Id.* ¶ 6.

75 *Id.* at 12.

76 OECD, *supra* note 11, ¶ 50.

77 *Id.* ¶ 56(1).

78 *Id.* at 29; BLUEPRINT, *supra* note 74, ¶ 9 ("The operation of the IIR is, in some respects, based on traditional controlled foreign company (CFC) rule principles . . . .").

79 The discussion of subsidiaries in this Part also includes branches.

refundable tax credits that do not meet these conditions as well as non-refundable tax credits should reduce the covered tax liability.[80]

Where the effective tax rate is below the global minimum tax rate, the top-up tax under the income inclusion rule would be the difference between the tax paid by the subsidiary and the tax that should be paid under the global minimum tax rate.[81] This means the tax under the income inclusion rule would generally be lower where a subsidiary receives a non-tax subsidy and pays tax on its income instead of receiving an equivalent tax benefit and paying no or low tax. This would also be the case where the undertaxed payments rule applies because this rule follows the income inclusion rule's methodology for the calculation of the subsidiary's effective tax rate and top-up tax.[82]

The subject to tax rule would result in additional taxation up to the global minimum tax rate where certain covered payments between connected persons are subject to an adjusted nominal tax rate below the minimum rate in the payee jurisdiction.[83] In general, covered payments include royalties, franchise fees, interest fees, and

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[80] BLUEPRINT, *supra* note 74, at 69. The conditions that refundable tax credits need to meet in order to be treated as income (i.e., to be classified as a "qualified refundable tax credit") are as follows:

> [T]he tax credit regime must be designed in a way so that a credit becomes refundable within 4 years from when it is first provided. Where the tax credit regime under the laws of a jurisdiction provides for partial refundability such that only a fixed percentage or portion of the credit is refundable, in order for the refundable portion of the credit to be treated as a qualified refundable tax credit, it must become refundable within 4 years from when it is first provided.
>
> Furthermore, if a refundable tax credit regime is determined to give rise to a material competitive distortion under the review process described below, a credit granted under such a regime will not be treated as a 'qualified refundable tax credit' under the GloBE.

Id.

[81] For further details on how the top-up tax is calculated and applied, see BLUEPRINT, *supra* note 74, at ¶¶ 410-52.

[82] *Id.* ¶¶ 12-19. Notably, the undertaxed payments rule is a secondary rule that would only apply where the income inclusion rule does not apply. *Id.* The allocation of the top-up tax under the undertaxed payments rule is different than that of the income inclusion rule. For the design details of this rule, see *id.* at 121-41. The Blueprint refers to the income inclusion rule and the undertaxed payments rule as the GloBE rules. *See id.* at 15.

[83] *Id.* ¶¶ 20, 566-667.

other payments.[84] The OECD proposes that preferential tax rates that apply to a covered payment (e.g., royalties) should reduce the adjusted nominal tax rate.[85] This means that granting tax benefits would increase the risk of tax under the subject of tax rule. The tax under this rule would be lower where a subsidiary is subject to a higher adjusted nominal tax rate on covered payments and receives a non-tax subsidy, instead of receiving an equivalent tax benefit (that reduces the adjusted nominal tax rate) and paying no or low tax on the relevant payment.

An important design question is whether the GloBE regime would allow for carve-outs for income from substantial activities in the relevant jurisdictions. The OECD previously noted that carve-outs would "undermine the policy intent and effectiveness of the GloBE proposal."[86] However, "some jurisdictions have stressed the importance of including substance carve-outs because, in their view, such carve-outs are necessary to ensure that the focus of Pillar Two is on remaining BEPS issues."[87] The OECD now proposes adopting formulaic substance-based carve-outs based on payroll and tangible assets, providing that a "modest return" on expenditures on payroll and tangible assets would be excluded.[88] The OECD noted that, "provided the amount of the carve-out is limited to a modest return (sometimes referred to as a 'routine return') on expenditures for payroll and tangible assets, then the MNE will not generally be able to use the carve-out to shelter other low-tax returns in a particular jurisdiction."[89] The proposed carve-outs might not fully exclude income benefitting from non-harmful preferential tax regimes. If this is the case and the proposed carve-outs are adopted, then the attractiveness of such preferential tax regimes would decrease

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[84] *See id.* ¶¶ 588-616. These other payments include insurance/reinsurance premiums, guarantee, brokerage or financing fees, rental payments for using moveable property, and "an amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services." *Id.* at 156.

[85] *Id.* ¶ 640.

[86] OECD, *supra* note 11, at 29.

[87] OECD, OECD/G20 BASE EROSION AND PROJECT SHIFTING PROJECT: STATEMENT BY THE OECD/G20 INCLUSIVE FRAMEWORK ON BEPS ON THE TWO-PILLAR APPROACH TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY ¶ 12 (2020), https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf [https://perma.cc/UA3G-UX7Z].

[88] BLUEPRINT, *supra* note 74, at 92-100.

[89] *Id.* ¶ 333.

because the MNEs would still be taxed on the relevant income. This would increase countries' motivation to replace such tax incentives with non-tax subsidies.[90]

Another important design question concerns "blending": "the extent to which an MNE can combine high-tax and low-tax income from different sources taking into account the relevant taxes on such income in determining the effective (blended) tax rate on such income."[91] If the global minimum tax is implemented based on worldwide blending,[92] granting tax benefits is less likely to trigger a global minimum tax where the MNE's blended effective tax rate is above the minimum rate. Thus, the impact on tax incentives would be lower. However, if the GloBE rules are implemented on a country-by-country basis (jurisdictional blending) as proposed by the OECD,[93] this would make tax incentives less attractive (assuming that there is no carve-out for the income benefitting from these tax incentives) because the relevant income could be subject to a global minimum tax in other jurisdictions.

Other design features of the global minimum tax could influence the incentives that governments would offer to attract MNE investment. For example, if the chosen minimum tax rate is 10%, then governments can offer tax benefits that reduce the MNEs' effective tax rate down to this rate, and any further incentives could be granted as non-tax subsidies. To conclude, the OECD's proposal has the potential to further increase the tax-driven preference for non-tax subsidies, especially if adopted without carve-outs for non-harmful tax benefits.

IV. COUNTRIES' PREFERENCE FOR NON-TAX SUBSIDIES

Countries now have stronger incentives to adopt non-tax subsidies instead of equivalent tax incentives. As MNEs prefer non-tax subsidies to tax benefits for the reasons explained in Part III, countries can attract more MNE investment at the same economic

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[90] For further discussion about the implications of carve-outs, see DEVEREUX ET AL., *supra* note 68, at 18-19; DE BROE, DANON & CHAND, *supra* note 68, at 9-10.

[91] OECD, *supra* note 5, ¶ 11(b). For analysts' views on blending, see DEVEREUX ET AL., *supra* note 68, at 18; DE BROE, DANON & CHAND, *supra* note 68, at 8-9.

[92] Under the blended approach, the effective tax rate is calculated based on the MNE's tax liability and taxable income in all jurisdictions outside that of the parent company; OECD, *supra* note 5, at 7.

[93] BLUEPRINT, *supra* note 74, ¶ 285.

cost by offering non-tax subsidies instead of tax benefits. In addition, the OECD and the EU scrutinize the preferential tax regimes offered by countries around the world. Countries run the risk of being targeted by the OECD or the EU if they find they offer harmful preferential tax regimes. These risks can be avoided by offering non-tax subsidies instead of tax benefits.

a. OECD's Scrutiny Over Harmful Tax Practices

In a 1998 report, the OECD set up a policy to address the problem of harmful tax practices.[94] The report called for the creation of a Forum on Harmful Tax Practices ("FHTP") and developed a framework for assessing whether a preferential tax regime should be considered as harmful.[95] The assessment of whether a preferential tax regime is harmful should consider various factors. The five key factors are as follows:

> (i) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
> (ii) The regime is ring-fenced from the domestic economy.
> (iii) The regime lacks transparency.
> (iv) There is no effective exchange of information with respect to the regime.
> (v) The regime fails to require substantial activities.[96]

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[94] OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998), https://www.oecd.org/tax/harmful/1904176.pdf [https://perma.cc/6T89-B6X4].

[95] *See id.* ¶¶ 10, 18.

[96] OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: HARMFUL TAX PRACTICES – 2018 PROGRESS REPORT ON PREFERENTIAL REGIMES: INCLUSIVE FRAMEWORK ON BEPS: ACTION 5, ¶ 18 (2019), https://www.oecd-ilibrary.org/docserver/9789264311480-en.pdf?expires=1607962177&id=id&accname=guest&checksum=1CF12193CAA210699ED141838FF9DD68 [https://perma.cc/U6UP-GARL]. In addition to the key factors, there are other secondary factors: "(i) An artificial definition of the tax base. (ii) Failure to adhere to international transfer pricing principles. (iii) Foreign source income exempt from residence country taxation. (iv) Negotiable tax rate or tax base. (v) Existence of secrecy provisions." *Id.* ¶ 19. The factors in the OECD 1998 report were somewhat different and were updated as part of the BEPS project and the subsequent work of the OECD.

Since the 1998 report, the FHTP has been reviewing preferential regimes to ensure they are not harmful.[97] All countries that are members of the Inclusive Framework are subject to this review.[98] As of January 2019, the FHTP has reviewed 225 regimes.[99] As a result of this review, many regimes have been abolished or amended to remove features that put them at risk of being declared harmful.[100]

Non-tax subsidies are not within the scope of this standard. Action 5 provides that "[i]n order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country."[101] If an incentive is granted as a non-tax subsidy and not as a tax benefit, it is not within the scope of this review.

Where a preferential tax regime is at risk of being considered harmful, countries may offer an equivalent non-tax subsidy instead. However, unlike harmful tax benefits that are granted without requiring commensurate substantial activities in return, governments generally grant non-tax subsidies to MNEs for substantial activities they carry out in the relevant countries. For example, the Israeli government agreed to grant $1 billion to Intel for investing around $11 billion in manufacturing activities within the country.[102] It is unlikely the Israeli government would have agreed to provide this subsidy without Intel's undertaking of these activities in Israel. In contrast, governments are more likely to provide tax benefits to geographically mobile income without requiring commensurate substantial activities in return.[103] This means governments are generally less likely to replace harmful tax

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97 *See id.* at 13.

98 *Id.* at 9.

99 *Id.* at 10.

100 *See id.* at 17-32.

101 OECD, *supra* note 58, ¶ 13.

102 Alisa Odenheimer, *Intel to Invest an Unprecedented $11 Billion in Israel Factory*, BLOOMBERG (Jan. 29, 2019), https://www.bloomberg.com/news/articles/2019-01-29/intel-to-invest-11-billion-in-israel-finance-minister-says.

103 For example, a patent box that grants an exemption for income from intellectual property has been developed in other jurisdictions. *See generally* Fabian Gaessler, Bronwyn H. Hall & Dietmar Harhoff, *Should There be Lower Taxes on Patent Income?* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24843, 2019) (indicating that certain countries have established special tax treatments, known as patent boxes, for corporate income derived from patents to encourage innovation). Under Action 5, BEPS-compliant patent boxes must have a substance requirement (the tax benefit is limited to the income attributed to the relevant jurisdiction based on the proportionate R&D expenditure in that jurisdiction); OECD, *supra* note 58, at 24-25.

benefits with equivalent non-tax subsidies that do not require substantial activities.

Nonetheless, there is still some risk that some jurisdictions might grant subsidies calculated in reference to the MNEs' tax liability without requiring commensurate substantial activities in return. For example, instead of granting a tax benefit of $400, a government can collect $400 as tax and grant $400 as a non-tax subsidy to offset the recipient's tax liability. Where subsidies are designed to offset the recipients' tax liability, they could be viewed as tax benefits in disguise. It should also be noted that a failure to require substance is only one of the factors in determining whether a regime is harmful.[104] A tax incentive scheme might be classified as harmful if it is ring-fenced from the domestic economy, it lacks transparency, or if there is no effective exchange of information with respect to the regime. Equivalent non-tax subsidies would not be subject to similar scrutiny. The OECD and some countries may view such non-tax subsidies as an attempt to circumvent the international standard on harmful tax competition. However, it is unclear if it is possible to take any action against non-tax subsidies within the existing framework.[105] In addition, there might be an information problem—the OECD and other countries may not be able to identify and detect instances where countries grant non-tax subsidies instead of equivalent harmful tax benefits. If a non-tax subsidy is not required to be reported under other laws, the OECD and other countries might not know that a country is engaged in harmful subsidy competition. Discretionary and selective non-tax subsidies might be less transparent and harder to monitor.[106]

b. EU's Blacklisting of Non-Cooperative Jurisdictions

In 1997, the EU adopted the Code of Conduct for Business Taxation with the purpose of curbing harmful tax competition

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[104] For the list of factors, see OECD, *supra* note 96, and accompanying text.

[105] Nonetheless, as noted above, if a subsidy is directly linked to the taxpayer's income or tax liability, there is a higher risk that the OECD will treat the subsidy as a tax benefit.

[106] There might be little or no transparency with respect to how the discretion is exercised.

among its Member States.[107] The Code of Conduct provides that the assessment of tax measures to determine whether they are harmful should include several factors, such as whether the tax benefits are ring-fenced.[108] Tax benefits are ring-fenced when they are only available to foreigners or to transactions with foreigners, or the benefits are otherwise ring-fenced from the domestic market so that the national tax base is unaffected by these tax benefits.[109]

In 2016, the EU decided on the criteria and the process that led to the EU list of non-cooperative jurisdictions for tax purposes in 2017.[110] The criteria include whether the jurisdictions comply with the international standards on tax transparency, the BEPS minimum standards and the EU's standard of fair taxation. Under the latter criterion, jurisdictions should not have preferential tax measures that could be classified as harmful under the Code of Conduct, and they "should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction."[111]

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107 Conclusions of the ECOFIN Council Meeting Concerning Taxation Policy, 1998 O.J. (C2) 1, https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/coc_en.pdf [https://perma.cc/4ELE-M3HS].

108 The EU's list of factors is as follows:

> 1. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or
>
> 2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or
>
> 3. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
>
> 4. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or
>
> 5. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.

Id. at 3.

109 *Id.* at 3.

110 Council Conclusions on the Criteria for and Process Leading to the Establishment of the EU List of Non-Cooperative Jurisdictions for Tax Purposes, 2016 O.J. (C 461) 2.

111 *Id.* § 2.2.

In December 2017, the EU published a list of non-cooperative tax jurisdictions, which included seventeen non-EU jurisdictions.[112] Eight of the seventeen jurisdictions that were blacklisted had harmful preferential tax regimes as the factor or one of the factors that resulted in their blacklisting.[113] The EU noted that "effective and proportionate defensive measures, in both non-tax and tax areas could be applied by the EU and Member States vis-à-vis the non-cooperative jurisdictions, as long as they are part of such list . . . ."[114] The EU noted that the Member States should increase administrative measures targeting the relevant jurisdictions or taxpayers benefiting from the relevant regimes.[115] It also noted that Member States can apply various other defensive measures, such as, inter alia, non-deductibility of certain expenses, withholding tax measures, stricter CFC rules, special documentation and disclosure requirements.[116]

The EU's definition of harmful preferential tax regimes appears to be broader than the BEPS Action 5 definition, as made apparent by the blacklisting of South Korea. The EU noted that "Korea has harmful preferential tax regimes and did not commit to amending or abolishing them by 31 December 2018."[117] The blacklisting of Korea was particularly surprising because Korea is a G20 and OECD member, it has been committed to the implementation of BEPS,[118] and the OECD did not find Korea's preferential tax regimes to be harmful.[119] However, it appears that the EU holds a stricter position regarding ring-fenced preferential tax regimes that are only available to foreign investors.

The Korean government objected to the EU's determination that its ring-fenced preferential tax regimes for foreign investment

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112 *The EU List of Non-Cooperative Jurisdictions for Tax Purposes*, at 8-9, 2019 O.J. (C 438). These jurisdictions are American Samoa, Bahrain, Barbados, Grenada, Guam, Republic of Korea, Macao SAR, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samoa, Trinidad and Tobago, Tunisia, and United Arab Emirates. *Id.*

113 These eight jurisdictions are Barbados, Republic of Korea, Namibia, Panama, Saint Lucia, Samoa, Trinidad and Tobago, and Tunisia. *See id.*

114 *Id.* at 6.

115 *See id.* at 13.

116 *See id.* at 13-14.

117 *Id.* at 8.

118 *See*, *e.g.*, Ted Tae-Gyung Kim, *Tax Transparency and Disclosure in Korea*, 72 BULL. FOR INT'L TAX'N 360 (June 2018). "Korea has actively participated in the implementation of international standards proposed by the OECD." *Id.* at 360.

119 *See id.* at 363 (noting that no harmful tax regimes were found in Korea in a recent 2017 review by members of the Inclusive Framework on BEPS); OECD, *supra* note 96, ¶ 46.

(which include its foreign investment zones and free economic zones, available only to foreign investors) are harmful preferential tax regimes.[120] The Korean government stressed the fact that "the EU has expanded the OECD's BEPS standards to include the manufacturing sector," which goes beyond the OECD application of the preferential tax regime standard only to easily mobile activities, such as finance and services.[121] Although Korea protested that the EU's decision violates Korea's tax sovereignty because it imposes EU standards on non-EU countries,[122] Korea decided to yield and committed to repealing or amending its preferential tax regimes. Following this commitment, the EU removed Korea from the list in January 2018.[123] Seven other blacklisted jurisdictions were also removed from the list at that time after they made similar commitments.[124] Korea repealed the ring-fenced tax incentives for foreign investors in late 2018.[125]

The EU criteria for determining whether a jurisdiction is a non-cooperative jurisdiction for tax purposes, including the EU standards on what would be considered harmful preferential tax regimes, do not cover or address non-tax subsidy regimes. Thus, countries can avoid blacklisting by offering ring-fenced non-tax subsidy regimes that would be classified as harmful if they were granted equivalent tax benefits. Many countries, such as Korea, already offer a mix of various investment incentives, including cash

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120 *See* Press Release, Ministry of Strategy & Fin. of S. Korea., Government Position on EU Announcement of the List of 17 Non-Cooperative Jurisdictions (Dec. 6, 2017), https://english.moef.go.kr/ec/selectTbEconomicDtl.do%3bjsessionid=Y9dRxb3CFHCcCQWV0+9vYpnW.node10?boardCd=E0003&seq=4403&boardCdKey=N [https://perma.cc/TNC2-WYMP] (detailing the reasons for the ministry's rejection of the EU's determination).

121 *Id.*

122 *Id.*

123 European Union Press Release, Taxation: Eight Jurisdictions Removed from EU List (Jan. 24, 2018), https://eeas.europa.eu/delegations/canada/38654/taxation-eight-jurisdictions-removed-eu-list_en [https://perma.cc/Y4PC-HUDU].

124 *Id.* These jurisdictions are Barbados, Grenada, Macao SAR, Mongolia, Panama, Tunisia, and the United Arab Emirates.

125 *Korea Enacts 2019 Tax Reform Bill*, EY GLOBAL (Jan. 2, 2019), https://www.ey.com/en_gl/tax-alerts/korea-enacts-2019-tax-reform-bill [https://perma.cc/2ZMN-JEE9]. The current EU list of non-cooperative jurisdictions for tax purposes includes American Samoa, Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands, and Vanuatu. Conclusions on the Revised EU List of Non-Cooperative Jurisdictions for Tax Purposes, 2020 O.J. (C 64) 8.

grants and other non-tax subsidies,[126] which could be expanded as the ability of these countries to attract foreign investment by offering tax incentives becomes more limited.

V. POLICY ANALYSIS AND PROPOSED CHANGES

What are the policy implications of this tax-driven preference for non-tax subsidies? This Part analyzes the relevant policy considerations. It also considers how other legal frameworks that regulate subsidies—the WTO subsidy rules and the EU state aid rules—apply to tax and non-tax subsidies. Based on this analysis, this Article contends that the international tax standards should not create a preference for non-tax subsidies over equivalent tax benefits. Following this approach, this Part proposes several changes in the international tax standards.

a. Tax Policy Considerations

The preference for non-tax subsidies over equivalent tax subsidies might result in distortions and welfare losses. Treating equivalent non-harmful tax subsidies and non-tax subsidies differently could result in suboptimal governmental policies. A recent OECD report on R&D tax and non-tax incentives noted that "[a]n optimal policy mix will likely require a combination of both direct and indirect [i.e., tax] support instruments."[127] According to Weisbach and Nussim, the choice between an equivalent tax expenditure and a spending program should depend on which agency would optimally administer the scheme.[128] The tax-driven preference for non-tax subsidies might result in an efficiency cost

126 *See*, *e.g.*, *FDI Procedures & Incentives*, INVEST KOREA (2017), http://www.investkorea.org/en/foreigner/invest.do [https://perma.cc/BYX7-ZQZT].

127 *See* Silvia Appelt, Fernando Galindo-Rueda & Ana Cinta Gonzalez Carbal, *Measuring R&D Tax Support: Findings from the New OECD R&D Tax Incentives Database* 47 (OECD Sci., Tech. & Indus., Working Paper No. 2019/06, 2019), https://www.oecd-ilibrary.org/docserver/d16e6072-en.pdf?expires=1607966060&id=id&accname=guest&checksum=B3D0B093CAD27BFD955C7583A84E2AD2 [https://perma.cc/8RQD-VBFZ].

128 *See* Weisbach & Nussim, *supra* note 15, at 957 (arguing that the decision to use the tax system to carry out a non-tax program is not a question of tax policy but rather one of institutional design).

where the optimal instrument is a tax benefit and the optimal choice is distorted by the tax-driven preference for non-tax subsidies.

Welfare losses may occur where non-harmful tax benefits that increase welfare cannot be replaced with equivalent non-tax subsidies, or where they can be replaced but at a high cost. For example, assume that a government offers non-harmful investment tax benefits that increase the national welfare in the relevant country.[129] As discussed in the previous Parts, recent international tax reforms make these tax incentives less attractive for MNEs. There should be no welfare loss if the government can replace the tax benefits with equivalent non-tax subsidies with no additional cost. However, some governments may not be able to easily replace tax incentives with equivalent non-tax subsidies. This might be the result of budgetary rules that impose more restrictions on non-tax subsidies or political economy considerations. Welfare losses might occur where welfare-increasing tax benefits become less attractive and they cannot be replaced with equivalent non-tax subsidies.

On the other hand, where tax incentives decrease the national welfare,[130] there may be a welfare gain if the tax benefits become less attractive and they are not replaced with equivalent subsidies. This could lead to the repeal of such inefficient tax incentives or to a decrease in the uptake of such incentives. As we expect that some tax incentive programs are efficient and some are not, the impact should be mixed. However, even if some tax incentive schemes are suboptimal, it is unclear whether the international tax norms should disfavor both optimal and suboptimal tax benefits as a way to reduce the use of the suboptimal ones.

With respect to harmful preferential tax regimes, some countries might replace such tax benefits with equivalent harmful non-tax subsidies as discussed in Part IV. As discussed above, it is unlikely that governments will replace harmful tax incentives that do not require economic substance with equivalent subsidies. However, there is some risk that some governments might grant subsidies designed to offset the recipients' tax liability without requiring commensurate substantial activities in return. Countries may also offer ring-fenced non-tax subsidies that the EU and other countries might find problematic if equivalent tax benefits were granted.

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129 This may be the case where the investment incentives substantially increase foreign direct investment and employment, resulting in domestic spillovers.

130 This would be the case if the cost of the incentive regime exceeds the resulting benefits.

Another consideration concerns the transparency of equivalent tax incentives and non-tax subsidies. The BEPS standards substantially increase the transparency of tax incentives, as tax rulings must be exchanged under Action 5, and even in the absence of a reportable tax ruling, a CbC report would show if an MNE paid no or low tax in a particular jurisdiction. Equivalent non-tax subsidies would be less transparent if the disclosure is not required under other laws.[131] In most cases, where a non-tax subsidy is granted for substantial activities in the relevant jurisdiction, other jurisdictions are unlikely to be harmed by the lack of transparency. However, if some countries adopt subsidies designed to offset the recipients' tax liability (which effectively makes them tax subsidies in disguise), then the lack of transparency becomes problematic. From an EU standpoint, the lack of transparency concerning ring-fenced subsidies might be problematic. To address these issues, it is possible to require the disclosure of potentially harmful non-tax subsidies where the disclosure of equivalent tax benefits is required.

Additionally, different tax treatment for equivalent tax benefits and non-tax subsidies might be inconsistent with the principle of tax fairness (i.e., horizontal equity), which is the notion that the tax system should treat similarly situated taxpayers similarly.[132] As shown in this Article, an MNE that receives a non-tax subsidy would have an advantage over an MNE that receives an equivalent tax benefit. As these measures are equivalent, these two MNEs are similarly situated and should be treated similarly under the tax system. Therefore, following the principle of tax fairness would require treating MNEs that receive equivalent tax and non-tax incentives similarly.

Therefore, this Article argues that the international tax standards should not create a preference for non-tax subsidies over equivalent tax benefits. A framework that treats equivalent tax and non-tax subsidies similarly would be more efficient for the reasons discussed above. Also, it would be consistent with the principle of horizontal equity and would improve transparency.

This approach is similar to the approach adopted in the WTO subsidy rules and the EU state aid rules, as these legal frameworks

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131 Disclosure of certain subsidies may be required under domestic law, the WTO subsidy rules, and the EU state aid rules. *See* sources cited *supra* note 60 (describing Commission regulations and WTO rules governing disclosure of certain subsidies). However, many subsidies might not fall within the scope of these rules.

132 *See*, *e.g.*, Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323, 1324-25 (2008), and the literature reviewed there on horizontal equity.

generally treat equivalent tax and non-tax subsidies similarly. Under the WTO's Agreement on Subsidies and Countervailing Measures, a subsidy exists where a benefit is conferred through a financial contribution by a government or a public body, or through any form of income or price support.[133] Financial contribution is defined broadly, and it includes "government revenue that is otherwise due [that] is foregone or not collected [e.g. fiscal incentives such as tax credits]."[134] Hence, the WTO rules generally apply to subsidies irrespective of whether they are provided as tax benefits, grants, or other forms of financial contribution. The EU rules on state aid apply to aid measures "in any form whatsoever,"[135] including tax measures.[136] In general, a tax measure is considered an "aid" if it reduces the firm's tax burden, it is granted through state resources (including as a loss of tax revenue), it affects competition and trade between the EU Member States, and it is specific or selective.[137] Under these rules, subsidies and equivalent

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133 WTO Subsidies Agreement, *supra* note 17, art. 1.1.

134 *See id.* (footnote omitted). Under art. 1.1(a)(1), "financial contribution" exists where:

> (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
>
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
>
> (iii) a government provides goods or services other than general infrastructure, or purchases goods;
>
> (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

Id.

135 Consolidated Version of the Treaty on the Functioning of the European Union art. 107(1), Sept. 5, 2008, 2008 O.J. (C 115) 91.

136 *Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation*, 1998 O.J. (C 384) ¶ 8, https://ec.europa.eu/competition/state_aid/legislation/compilation/g_15_01_14_en.pdf [https://perma.cc/6M4J-QXHX] ("In applying the Community rules on State aid, it is irrelevant whether the measure is a tax measure, since Article 92 [now 107] applies to aid measures 'in any form whatsoever.'"). For further discussion, see Sandra Marco Colino, *The Long Arm of State Aid Law: Crushing Corporate Tax Avoidance*, 44 FORDHAM INT'L L.J. (forthcoming 2020).

137 *See Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation*, *supra* note 137, ¶ 16. To be considered as aid, the measure should be "an exception to the application of the tax system." *Id.*

tax measures should generally be subject to similar treatment. Thus, the WTO rules on subsidies and the EU rules on state aid generally treat tax incentives and other subsidies similarly.

b. Proposed Changes in the International Tax Standards

The discussion below sets forth several proposals for changes in the international tax standards to achieve similar treatment of equivalent tax benefits and non-tax subsidies. If policymakers accept the principle that equivalent tax incentives and non-tax subsidies should be treated similarly, the implementation details of these proposals could be further developed.

i. CbC Reports

As discussed in Section III.a, non-harmful tax incentives negatively affect the CbC report because the tax liability and the effective tax rate are lower in comparison to a CbC report of an MNE that receives a non-tax subsidy and pays tax on the income in the relevant jurisdiction. This could be addressed by disclosing in an additional column in the CbC report the estimated income tax that would apply if a non-harmful tax benefit were granted as an equivalent non-tax subsidy. For example, assume that the tax incentive schemes in a particular country were found to be non-harmful. If these tax incentives were replaced with equivalent non-tax subsidies, then the tax liability in that country would have been higher as demonstrated in Section III.a. The proposed additional column would report that simulated tax liability. To implement this proposal, there should be guidance on how to quantify the tax subsidy and calculate the simulated tax liability.[138] This additional information can assist tax authorities when they review CbC reports to conduct risk assessment to identify suspected instances of artificial profit shifting. Providing this additional information could reduce the risk that MNEs would be suspected of profit shifting

[138] Among other matters, the guidance should address the following issues: what tax rate should be used to quantify the tax subsidy and calculate the simulated tax liability on an equivalent subsidy (the jurisdiction's statutory tax rate, the MNE's effective tax rate or the marginal tax rate) and whether it should be assumed that the equivalent non-tax subsidy is subject to tax in the relevant jurisdiction.

where the low tax liability is a result of receiving non-harmful tax benefits.

While tax incentives are reflected in the CbC report, equivalent non-tax subsidies (including potentially harmful subsidies) are not reflected in the CbC report. This could be addressed by requiring the disclosure of subsidies, defined broadly,[139] in an additional column in the CbC report. This information would allow countries to inquire whether the subsidies offered by other countries are equivalent to harmful tax measures. This would also enable countries and international bodies, such as the OECD, to assess the magnitude of the international subsidy competition. It is possible to adopt a narrower disclosure requirement that would only apply to subsidies that have certain features which raise the suspicion they might be harmful (e.g., subsidies calculated in reference to the recipients' tax position).

ii. Spontaneous Exchange of Tax Rulings and Scrutiny over Harmful Tax Practices

As noted in Section III.b., under the rules on the spontaneous exchange of tax rulings, governments are not subject to a similar reporting requirement when they offer subsidy rulings that have the same economic effect as reportable tax rulings. Although countries are less likely to grant non-tax subsidies without requiring commensurate substantial activities in return, there is some risk that some countries might offer subsidies designed to offset the recipients' tax liability. Such subsidies could be viewed as tax benefits in disguise. This risk can be addressed by requiring the spontaneous exchange of information about subsidies calculated based on the recipients' tax position. This would require expanding the "ruling" definition.[140] Similarly, the OECD's and the EU's scrutiny over harmful tax practices could also include subsidies connected to recipients' tax position or designed to offset the recipients' tax liability.

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[139] The subsidy definition for this purpose can follow the WTO's subsidy definition, as discussed in the text accompanying *supra* note 134.

[140] As discussed above, the current definition of "ruling" is "any advice provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely." *See* OECD, *supra* note 58 and accompanying text.

iii. Recommended CFC Rules and the GloBE Proposal

As discussed in Section III.c., the OECD recommendations for CFC rules favor CFCs which receive non-tax subsidies and disfavor CFCs that receive equivalent tax benefits. A CFC that receives a non-tax subsidy and pays tax is more likely to qualify for a tax rate exemption. Even if the effective tax rate is below the exemption threshold, a parent of a CFC that receives a non-tax subsidy and pays tax on its income would be able to claim a credit for the tax the CFC paid. A parent of a CFC cannot claim any credit if the CFC receives a tax benefit and does not pay tax.

A similar treatment for non-harmful tax benefits and equivalent subsidies can be accomplished by providing carve-outs for non-harmful tax incentive schemes so that CFC income would not include income that benefited from these tax incentives. Alternatively, similar to the proposal above concerning the CbC reporting, it is possible to take into account, in the application of the CFC rules, the simulated income tax that would apply if the tax benefits were structured as a non-tax subsidy. The simulated effective tax rate can be used as the CFC's effective tax rate for the purposes of the CFC rules. In addition, the parent of the CFC should be able to use a tax credit based on the CFC's simulated tax liability.

Similar issues arise in the context of the OECD's recent GloBE proposal, discussed in Section III.d. If the GloBE rules are adopted without carve-outs for income benefitting from non-harmful tax incentives, this would further reduce the benefit from such tax incentives and increase the preference for non-tax subsidies. In order to treat equivalent non-harmful tax and non-tax subsidies similarly, the GloBE rules could include carve-outs for non-harmful tax incentive schemes. Similarly, when calculating the adjusted nominal tax rate when applying the subject to tax rule, this rate should not be reduced because of non-harmful preferential tax incentives.

VI. CONCLUDING REMARKS

The international community has been dealing with the challenges of harmful tax competition for decades. As the efforts to curb certain forms of tax competition have intensified in recent years, it is important to consider the potential impacts of recent international tax reforms on other forms of competition among countries.

This Article makes two contributions to the literature on tax policy and international economic law. First, it shows how recent international tax reforms encourage the adoption of non-tax subsidies over equivalent tax incentives. Second, the Article analyzes the policy considerations and implications of the tax-driven preference for non-tax subsidies. Based on this analysis, the Article recommends that the international tax standards be amended so they would treat equivalent tax and non-tax incentives similarly. The Article also outlines several changes in the international tax standards that could advance this goal.